Arena Proposal and Initiative 91's "Fair Value"

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Overview

- Initiative 91’s “Fair Value” Requirements
- Council Policy Options
- Executive’s Proposed Alternative
- Another Proposed Alternative

Initiative 91

1. "Consideration … must be at or above the **fair value** of the goods, services, real property or facility being leased or provided."

2. "[The fair value] return shall be computed as the **net cash on cash return**…."

3. The net cash on cash return must be "no less than the rate of return on a **U.S. Treasury Bond**…."

Key Terms: Cash on Cash Return

- Investment term of art
- Measure of performance for an investment that is financed with cash and debt

Cash on Cash Return = (Net Proceeds) ÷ (Cash)

Arena Proposal

- I-91 requires City to receive a cash on cash return at or above U.S. Treasuries Bill

- Does the Arena provide the City with a "cash on cash return" above U.S. Treasuries Bill?

Cash on Cash Return = Net Proceeds ÷ Cash

- Cannot be calculated because "Cash" = $0

Council Policy Options

1. Council could exempt arena from I-91; or

2. Council could find that the arena proposal's "fair value" cannot be calculated; or

3. Council could find that "fair value" is still required and evaluate the arena proposal using an alternate approach (i.e., replace "cash on cash return" with another concept)

Executive’s Proposed Alternative:
Brief Review

Application to Proposal

- City is not contributing any cash; public investment is all borrowed funds

$$\frac{\text{Annual Cash Flow}}{\text{Total Cash Invested}} = \text{N/A}$$

- "Cash on Cash" return calculation called for in I-91 cannot be directly applied

- Alternate approach required to evaluate proposal's return relative to 30-year treasury bond

Slide from Executive's 6/29 /12 Presentation to GPAF Committee

Analysis

Approach

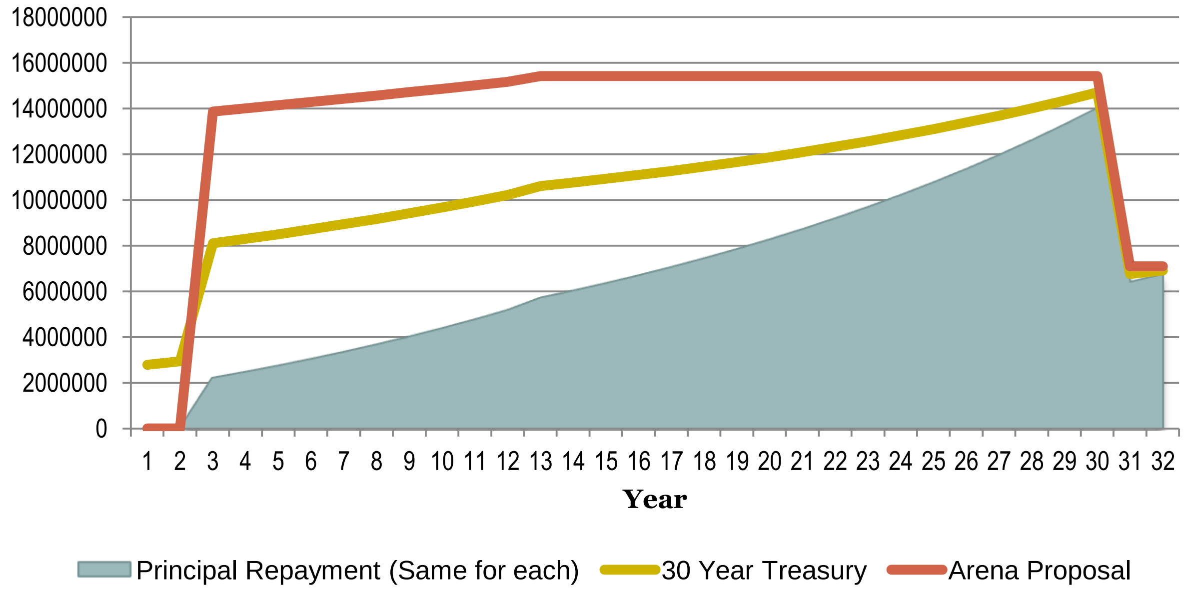
Cash Scenario

Debt Scenario

Slide from Executive's 6/29 /12 Presentation to GPAF Committee

- Below illustrates the revenue streams, including principal repayment, of the arena proposal and a treasury return.
- The shaded area is principal repayment for both scenarios.

Annual revenue guaranteed: arena proposal vs 30-year treasury return
(Shaded region reflects principal repayment for both streams)



Executive's Proposed Alternate

- Council could accept the Executive's proposed alternate I-91 "fair value" test and accept the conclusion that the Arena meets the test

- City expects to borrow at a rate well above the U.S. Treasuries Bill rate, so this may not be the right benchmark for the proposed Arena

- Council might then evaluate whether the Arena provides a "fair value" using a different lens

Different Proposed Alternate

Key Terms: Fair Value

- Term of art in economics and accounting
- Rational and unbiased estimate of the potential market price of a good, service, or asset
- Price that is fair between two specific parties
- The estimated price for the transfer of an asset or liability between identified knowledgeable and willing parties that reflects the respective interests of those parties

Arena Proposal

- Policy decision to count incremental taxes as "payment"

- City will incur some level of risk:
  - City will pledge its full faith and credit to pay debt service every year; and
  - City will rely on ArenaCo's lease payments (incremental taxes and rent)
  - Securities and protections under the MOU

- In recognition of City's risk, "fair value" could be the rate of return that appropriately compensates the City for both its investment and attendant risks

Fair Value for Commercial Real Estate

- A commercial real estate investor could evaluate the “fair value” question using different lenses

- One important consideration would be cost of capital and expected return

- For an investment to be worthwhile, the expected return on capital should be greater than the cost of capital. The difference can be thought of as a “risk premium.”

Fair Value for Commercial Real Estate

- As a commercial real estate "investor," City would want both:
  - Some risk premium above cost of capital; AND
  - Maintain ownership of land and improvements

- Such a return would provide the "investor" (City) a risk premium over City's carrying costs (annual debt service costs).

- If such a return were not available, borrowing funds for this purpose would not be an attractive investment

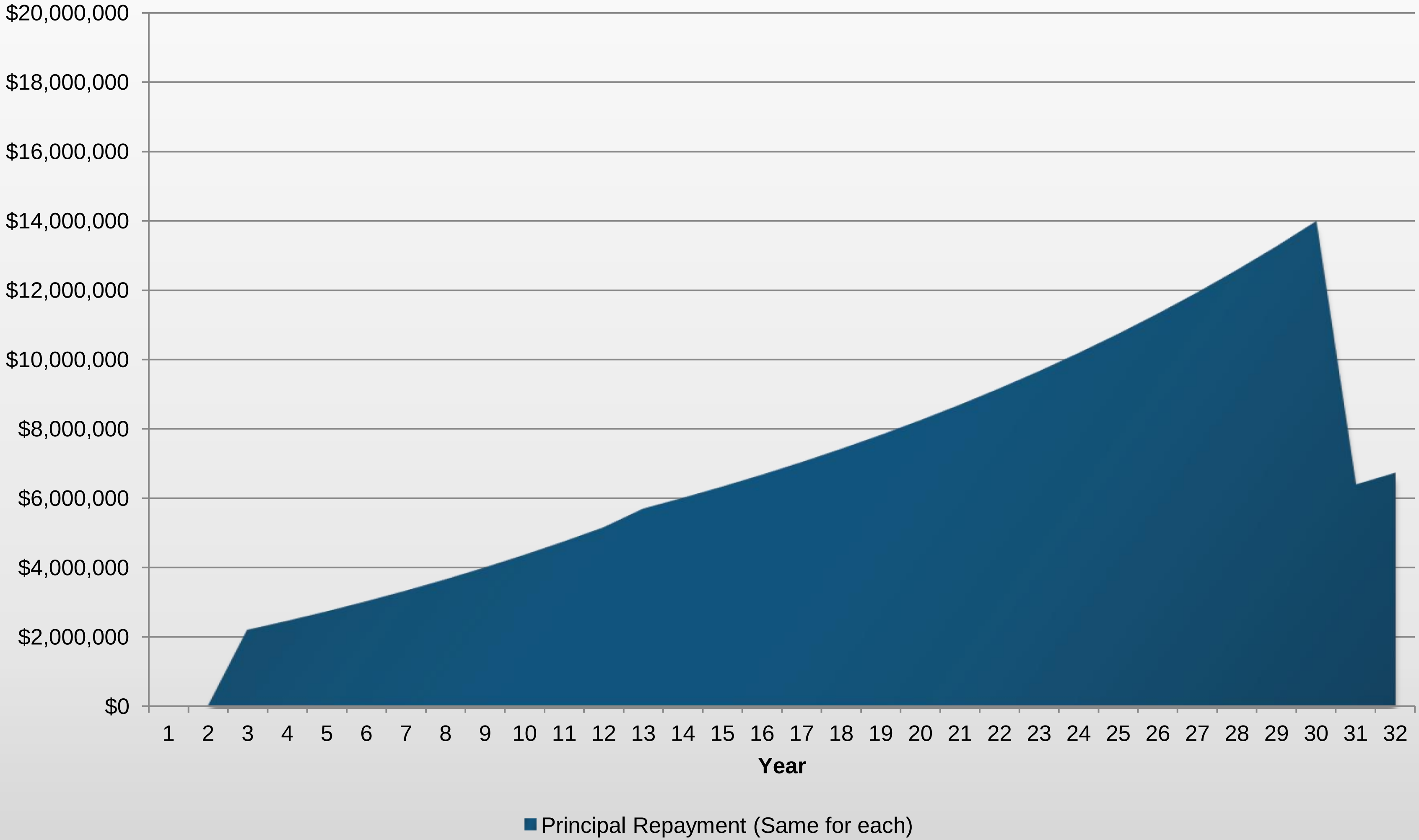
Fair Value for Commercial Real Estate

- Putting land to use for a single-purpose arena facility is the kind of investment for which a risk premium is reasonable to expect

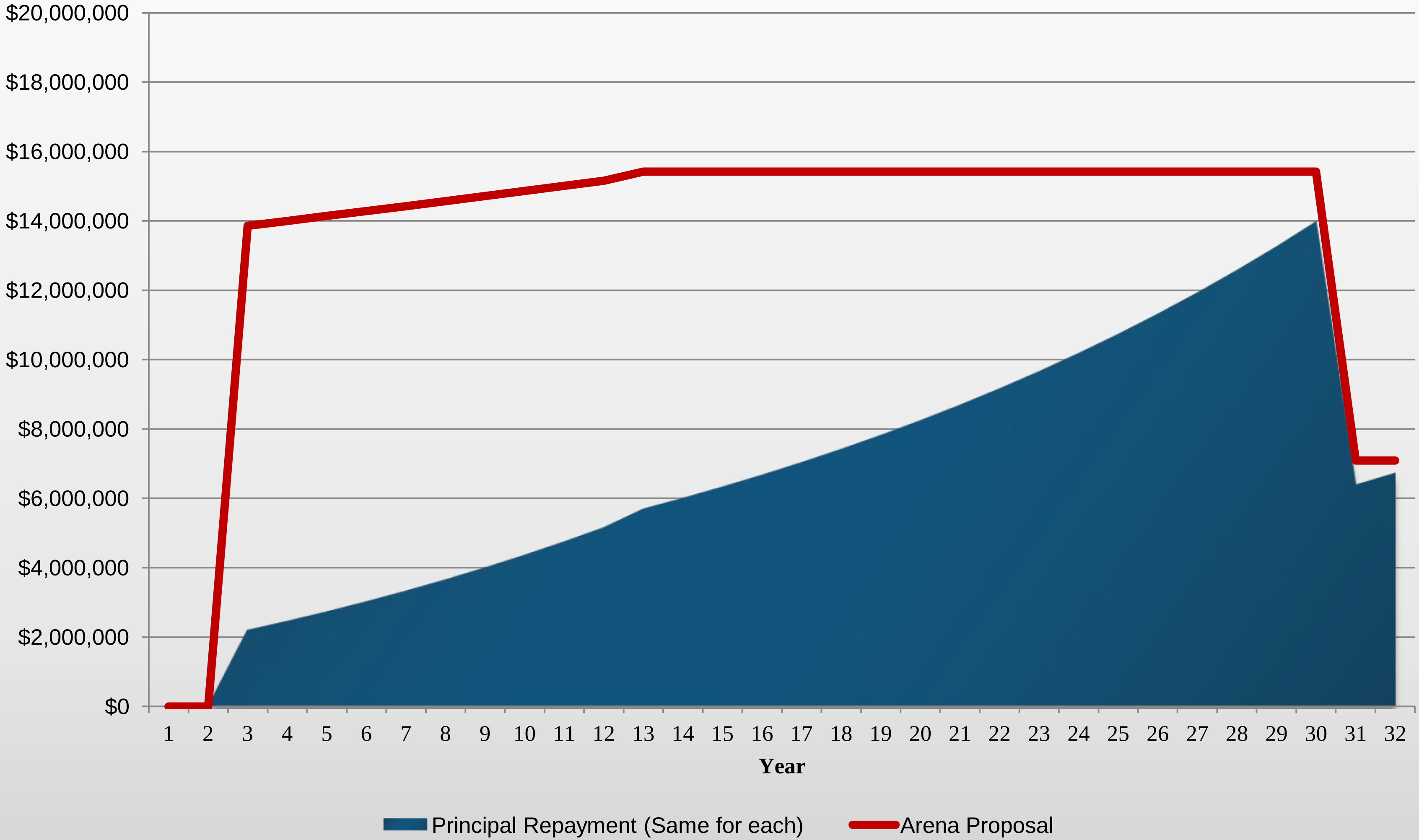
- Some factors – including annual capital contributions and various "guarantees"– do mitigate the risk to City; but basic deal structure is that ArenaCo pays no more than City/County debt service costs

- At the same time, substitution effects, which will decrease admission tax and sales tax receipts at other venues to at least some degree, imply the proposed agreement will not fully reimburse the City's annual debt service costs

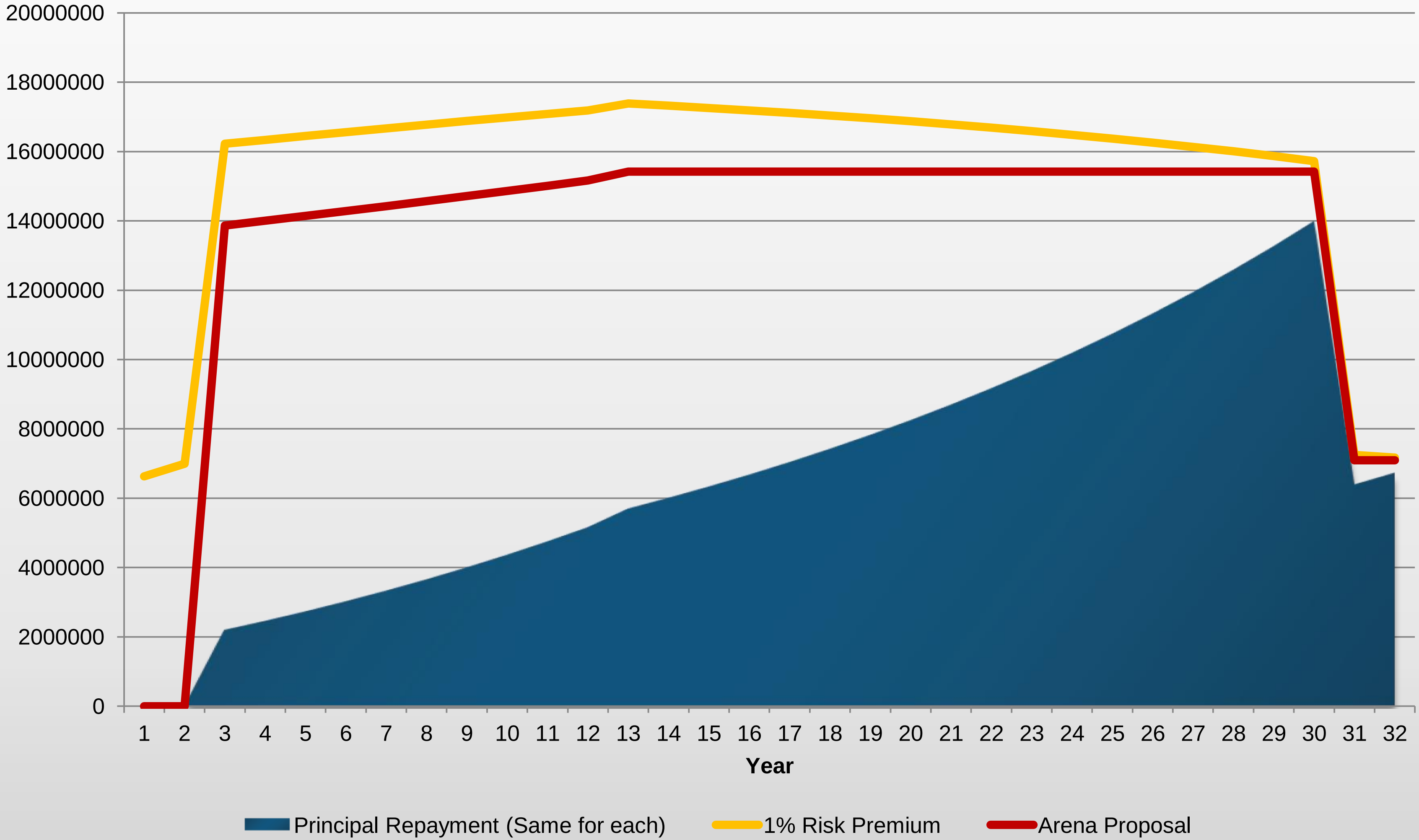
Arena vs. Commercial Investment



Arena vs. Commercial Investment



Arena vs. Commercial Investment



Alternative “Fair Value” Test

- Council use commercial real estate or risk premium approach as an alternate “fair value” test (instead of CBO’s proposed approach)
- Arena lease payments do not provide a return comparable to what a commercial investor would earn assuming a 1% risk premium
- Council could therefore conclude that the Arena does not meet the Fair Value test

Conclusions

- I-91 is clear about requiring Fair Value
- Fair Value calculation prescribed in I-91 is not directly applicable to this proposal
- Council has several policy options.
  - Exempt Arena from I-91
  - Determine that I-91 does not apply
  - Apply alternate "tests" to determine whether Arena is consistent with Fair Value requirement

Questions?